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TY:

Legend

Corporation X =

Corporation Y =

Corporation Z =

City =

State =

Partnership =

Fund =

Department G =

r =

Dear :

This is reply to your request for a ruling concerning whether all currently anticipated income of Corporation Y and Corporation Z will qualify for the exclusion from gross income under section 115 of the Code.

Facts

Corporation Y and Corporation Z were recently formed by a directive of the mayor of the City to take over the activities of Corporation X. Corporation X is a local development corporation under City nonprofit corporation law. Corporation X is recognized under federal tax law as a section 501(c)(3) organization and has received a private letter ruling holding that it is a wholly-owned instrumentality of the City. Corporation X serves as the City's primary vehicle for economic development.

Corporation X strives to lessen the burdens of government and to act in the public interest by promoting economic growth and development in the City, primarily by encouraging and coordinating the use of public and private funds for lending to, and investing in, various private businesses as well as private and public economic projects. Corporation X's activities on behalf of the City include managing property; undertaking capital projects; disposing of land; developing initiatives to support and expand specific economic sectors; serving as the City's development consultant; supporting organizations that promote economic development in the City; administering financial assistance and other incentive programs; advising the City on maritime, freight rail, and aviation policy; and developing workforce initiatives.

As part of its administration of economic development incentive programs, Corporation X formed the Fund as a wholly-owned subsidiary to invest in eligible seed and early-stage technology companies, with such investment intended as an incentive for private firms to invest in these same businesses. The Fund makes its investments in tandem with two funds managed by a private venture capital firm, which performs extensive due diligence to identify appropriate businesses for the program at no cost to the Fund. For each investment the Fund makes, one of the funds managed by the private venture capital firm will make an investment at least equal to the Fund's investment, with sufficient funds held in reserve to make significantly greater subsequent investments if appropriate.

All of Corporation X's income and earnings must be used exclusively for its corporate purposes or must accrue and be paid to Corporation M, a public benefit corporation under State law. No part of its income or other property may inure or be distributed to any private interest. Upon dissolution, any funds or property remaining after the satisfaction of liabilities must be distributed to the City.

The City controls the selection of Corporation X's members. The mayor appoints some of the members directly, some upon nomination by presidents of city political divisions, some upon nomination by an official of the City council, and one after consultation with the Partnership, with the latter appointee becoming the chairman of the board. The chairman then appoints a number of members from a list approved by the mayor. Appointments are made annually.

The members will elect each year from their number those who will serve as directors. Any director may be removed, with or without cause, at any membership meeting by majority vote.

The City controls the activities of Corporation X through two contracts (the "City Contracts") by which Corporation X provides economic development services for the City. Each contract has an annual term, subject to the City's right to extend it for up to 12 months. The City, through the deputy mayor and other City officials, has extensive

authority under the contracts to review, direct, and control Corporation X's programs and expenditures, including the inspection of books and records.

As a local authority under state law, Corporation X must comply with various requirements, such as those for financial reporting, corporate governance, and public disclosure. Corporation X is also subject to the public disclosure requirements of State law.

With only limited exceptions, Corporation X's funding is provided by the City or is generated by the performance of services under the City Contracts, with the vast majority of its expenditures being made out of funds from the City for specific projects. All of Corporation X's expenses are incurred performing services under the contracts. A significant amount of Corporation X's revenues and expenses arise from its administration of the City's electrical subsidy program for certain eligible businesses.

Through its extensive authority under the City Contracts to review and approve Corporation X's budget and project expenditures, as well as its authority to compel Corporation X to pay over Corporation X assets the fair market value of which exceed dollars, an amount specified in the contracts, the City has effective control over Corporation X's expenditures and financial assets.

Corporation X will merge into Corporation Y and Corporation Y will be the survivor of the merger. Corporation Y is a not-for-profit corporation but not a local development corporation. Corporation Y will further the public purposes for which Corporation X was formed, its governance structure will be identical to that of Corporation X, and it will become a party to the city contracts under which Corporation X operated. Corporation Y's activities will be substantially similar to Corporation X's, with two notable exceptions: in most cases Corporation Y will not acquire real estate by purchase or lease directly from the City for subsequent transfer to private parties, and Corporation Y will engage in legislative advocacy to influence federal, state, and local laws and policies affecting economic development in the City.

Because Corporation Y is not a local development corporation under state law, a new local development corporation, Corporation Z, also has been formed. Corporation Z will have five member/directors, all of them appointed annually by the mayor, with the mayor designating one as chairman of the board. No member of Corporation Z may be a member or director of Corporation Y. Any director may be removed, with or without cause, at any membership meeting by majority vote. After the merger of Corporation X and Corporation Y, Corporation Y will enter into agreements with private parties to sell or lease property to be acquired from the City. Corporation Z will purchase or lease property from the City and then transfer the property (by sale, assignment, or sublease) to Corporation Y or to a third party at Corporation Y's direction.

The primary purpose of the proposed transaction is to separate those functions of Corporation X that must be performed by a local development corporation from those that need not, enabling Corporation Y to participate in legislative advocacy activities that further its public purposes. The proposed merger of Corporation X and Corporation Y will be subject to review by the State attorney general and to approval by the State appellate court.

Section 115(1) of the Code provides that gross income does not include income derived from any public utility or the exercise of an essential governmental function and accruing to a state or a political subdivision of a state.

In Rev. Rul. 77-261, 1977-2 C.B. 45, income from an investment fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its participating political subdivisions, was found to be excludable from gross income for federal income tax purposes under § 115(1). The ruling indicated that the statutory exclusion was intended to extend not to the income of a state or municipality resulting from its own participation in activities, but rather to the income of a corporation or other entity engaged in the operation of a public utility or the performance of some governmental function that accrued to either a state or municipality. The ruling stated that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out projects that are desirable from the standpoint of a state government and which are within the ambit of a sovereign properly to conduct.

In Rev. Rul. 90-74, 1990-2 C.B. 34, the income of an organization formed, funded, and operated by political subdivisions to pool various risks arising from their obligations regarding casualties, public liability, workers' compensation, or employees' health was found to be excludable from gross income under § 115. The IRS determined in this ruling that private interests did not materially participate in the organization, nor did they benefit more than incidentally from the organization.

Corporation Y and Corporation Z were formed to further the public purposes for which Corporation X was formed. Acting together, Corporation Y and Corporation Z will serve as the City's primary vehicle for economic development, primarily by promoting the use of public and private funds as loans to, and investments in, various businesses and economic projects in the City. Promoting economic development constitutes the performance of an essential governmental function within the meaning of § 115(1). See Rev. Rul. 90-74 and Rev. Rul. 77-261.

All of Corporation Y's and Corporation Z's income and earnings must be used exclusively for corporate purposes or must accrue and be paid to Corporation M, a public benefit corporation under state law. None of the income or other property of Corporation Y and Corporation Z may inure to the benefit of, or be distributed to, any private interest. No private interests materially participate in the operation of, or

otherwise benefit more than incidentally from, Corporation Y and Corporation Z. In the event of Corporation Y's or Corporation Z's dissolution, any corporate assets remaining after satisfaction of liabilities will be distributed to the City or to Corporation M but only if the income of such an organization is excluded from gross income under § 115. See Rev. Rul. 90-74.

Based solely on the facts and representations submitted by Corporation Y and Corporation Z, we conclude that the income of Corporation Y and Corporation Z is derived from the exercise of an essential governmental function and will accrue to a state or a political subdivision thereof for purposes of § 115(1).

Consequently, we rule that the income of Corporation Y and the income of Corporation Z are excludable from gross income under § 115(1).

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Lynne Camillo
Branch Chief, Employment Tax Branch 2 (Exempt
Organizations/Employment Tax/Government
Entities)
(Tax Exempt & Government Entities)